Managing Credit Booms and Busts: A Pigouvian Taxation Approach^{*}

Olivier Jeanne Johns Hopkins University Anton Korinek University of Maryland

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Abstract

We study a dynamic model in which the interaction between debt accumulation and asset prices magnifies credit booms and busts. We find that borrowers do not internalize these feedback effects and therefore suffer from excessively large booms and busts in both credit flows and asset prices. We show that a Pigouvian tax on borrowing may induce borrowers to internalize these externalities and increase welfare. We calibrate the model by reference to (i) the US small and medium-sized enterprise sector and (ii) the household sector, and find the optimal tax to be countercyclical in both cases, dropping to zero in busts and rising to approximately half a percentage point of the amount of debt outstanding during booms.

JEL Codes: E44, G38 Keywords: boom-bust cycles, financial crises, systemic externalities, macro-prudential regulation, precautionary savings

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